

Behavioral Finance

*Understanding the Social,
Cognitive, and Economic Debates*

EDWIN T. BURTON
SUNIT N. SHAH

WILEY

Contents

Preface	xi
Introduction	1

PART ONE

Introduction to Behavioral Finance

CHAPTER 1

What Is the Efficient Market Hypothesis?	5
Information and the Efficient Market Hypothesis	6
Random Walk, the Martingale Hypothesis, and the EMH	8
False Evidence against the EMH	11
What Does It Mean to Disagree with the EMH?	13

CHAPTER 2

The EMH and the “Market Model”	15
Risk and Return—the Simplest View	15
The Capital Asset Pricing Model (CAPM)	18
So What Is the Market Model?	23

CHAPTER 3

The Forerunners to Behavioral Finance	25
The Folklore of Wall Street Traders	26
The Birth of Value Investing: Graham and Dodd	28
Financial News in a World of Ubiquitous Television and Internet	29

PART TWO

Noise Traders

CHAPTER 4

Noise Traders and the Law of One Price	33
The Law of One Price and the Case of Fungibility	33
Noise	38

CHAPTER 5**The Shleifer Model of Noise Trading 43**

The Key Components of the Shleifer Model 44

Results 49

Why the Shleifer Model Is Important 50

Resolving the Limits to Arbitrage Dispute 51

CHAPTER 6**Noise Trading Feedback Models 53**

The Hirshleifer Model 53

The Subrahmanyam-Titman Model 58

Conclusion 62

CHAPTER 7**Noise Traders as Technical Traders 65**

Technical Traders as Noise Traders 67

Herd Instinct Models 72

Conclusion 76

PART III**Anomalies****CHAPTER 8****The Rational Man 81**

Consumer Choice with Certainty 81

Consumer Choice with Uncertainty 84

The Allais Paradox 90

Conclusion 92

CHAPTER 9**Prospect Theory 93**

The Reference Point 93

The S-Curve 94

Loss Aversion 96

Prospect Theory in Practice 98

Drawbacks of Prospect Theory 98

Conclusion 100

CHAPTER 10	
Perception Biases	101
Saliency	101
Framing	103
Anchoring	106
Sunk Cost Bias	108
Conclusion	109
CHAPTER 11	
Inertial Effects	111
Endowment Effect	111
Status Quo Effect	116
Disposition Effect	119
Conclusion	120
CHAPTER 12	
Causality and Statistics	123
Representativeness	123
Conjunction Fallacy	127
Reading into Randomness	129
Small Sample Bias	131
Probability Neglect	133
Conclusion	134
CHAPTER 13	
Illusions	135
Illusion of Talent	135
Illusion of Skill	138
Illusion of Superiority	139
Illusion of Validity	141
Conclusion	142

PART IV**Serial Correlation**

CHAPTER 14	
Predictability of Stock Prices: Fama-French Leads the Way	147
Testing the Capital Asset Pricing Model	147
A Plug for Value Investing	149
Mean Reversion—The DeBondt-Thaler Research	151
Why Fama-French Is a Milestone for Behavioral Finance	152

CHAPTER 15

Fama-French and Mean Reversion: Which Is It?	155
The Month of January	155
Is This Just About Price?	157
The Overreaction Theme	157
Lakonishok, Shleifer, and Vishny on Value versus Growth	158
Is Overreaction Nothing More Than a “Small Stock” Effect?	159
Daniel and Titman on Unpriced Risk in Fama and French	164
Summing Up the Contrarian Debate	165

CHAPTER 16

Short Term Momentum	167
Price and Earnings Momentum	167
Earnings Momentum—Ball and Brown	168
Measuring Earnings Surprises	170
Why Does It Matter Whether Momentum Is Price or Earnings Based?	173
Hedge Funds and Momentum Strategies	174
Pricing and Earnings Momentum—Are They Real and Do They Matter?	174

CHAPTER 17

Calendar Effects	177
January Effects	178
The Other January Effect	180
The Weekend Effect	181
Preholiday Effects	182
Sullivan, Timmermann, and White	183
Conclusion	184

PART V**Other Topics****CHAPTER 18**

The Equity Premium Puzzle	187
Mehra and Prescott	187
What About Loss Aversion?	190
Could This Be Survivor Bias?	191
Other Explanations	192

Are Equities Always the Best Portfolio for the Long Run?	193
Is the Equity Premium Resolved?	194
CHAPTER 19	
Liquidity	195
A Securities Market Is a Bid-Ask Market	196
Measuring Liquidity	197
Is Liquidity a Priced Risk for Common Stocks?	199
Significance of Liquidity Research	200
CHAPTER 20	
Neuroeconomics	201
Capuchin Monkeys	201
Innateness Versus Culture	203
Decisions Are Made by the Brain	203
Decisions versus Outcomes	205
Neuroeconomic Modeling	206
More Complicated Models of Brain Activity	208
The Kagan Critique	208
Conclusion	209
CHAPTER 21	
Experimental Economics	211
Bubble Experiments	212
Endowment Effect and Status Quo Bias	215
Calendar Effects	216
Conclusion	216
CONCLUSION	
And the Winner Is?	217
The Semi-Strong Hypothesis—Prices Accurately Summarize All Known Public Information	217
Can Prices Change if Information Doesn't Change?	219
Is the Law of One Price Valid?	220
Three Research Agendas	221
The Critics Hold the High Ground	223
What Have We Learned?	223
Where Do We Go From Here? (What Have We Not Learned?)	227
A Final Thought	230
Index	231